

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

Number: **200842011**

Release Date: 10/17/2008

Index Number: 1388.00-00

[Third Party Communication:

Date of Communication: Month DD, YYYY]

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CC:P&SI:5

PLR-112531-08

Date:

July 11, 2008

In Re:

**LEGEND**

Cooperative =

Act =

Product =

Metropolitan Area =

Retail =

Dear :

This is in response to a request for a ruling dated March 6, 2008, submitted by your authorized representatives concerning the federal income tax consequences of a transaction involving a cooperative under subchapter T of the Internal Revenue Code as described below.

Cooperative was formed in as a corporation operating as a non-stock cooperative association pursuant to the Act. The Articles of Incorporation as originally filed in have not been altered, modified or otherwise amended.

According to the Cooperative's Articles of Incorporation, it was organized to operate a system to distribute Product of its members for their exclusive and mutual benefits as patrons of the Cooperative. Article Fourth of the Articles of Incorporation specifically provides that:

"The association is organized to operate a system to distribute the products of its members for their exclusive and mutual benefit as patrons of the association. The association shall have the power to purchase, lease, build, maintain and operate warehouses, garages and all other facilities for use in connection with operating said system; and to exercise all such powers in any capacity and on any cooperative basis as agreed on and permitted by law."

The Metropolitan Area consists of numerous local areas, both urban and suburban. The Metropolitan Area covers over        square miles and includes the        and parts of        and       , with a population over        people. There are multiple cities, towns and neighborhoods across the Metropolitan Area, and travel between locations is extremely time consuming.

Pursuant to Article Fifth of the Articles of Incorporation, membership in the Cooperative is restricted to retail merchants located in the Metropolitan Area who patronize the association. Applicants are eligible for membership in the Cooperative if they meet the qualifications stated in the Articles of Incorporation and the By-Laws, including making the required payment of a minimum membership fee of \$       .

Article Sixth of the Articles of Incorporation provides that the "property rights and interests of each members in the association shall be equal and shall be determined by the proportion that the patronage of each member shall bear to the total patronage of all the members with the association." Membership of the Cooperative currently consists of approximately        independent local Retail shops in the Metropolitan Area. Approximately        such shops have been members of the cooperative at one time or another.

The purpose of the Cooperative is to consolidate and share the delivery resources of its members to develop a spoke-hub distribution network and thereby increase the efficiency of deliveries throughout the Metropolitan Area. The spoke-hub distribution network allows the Cooperative's members, which are independent local businesses, to drop off their Product at a central location to facilitate deliveries by other members in their respective local areas. For instance, a       -based member will take Product deliveries that are not destined for its primary delivery area to the central location (hub). In turn, the        shop will pick up any Product destined for its primary delivery area. The Cooperative's spoke-hub distribution network has allowed its members to more efficiently serve customers in the Metropolitan Area.

To cover the operating costs of the Cooperative, each member is charged a certain amount for each item dropped off for delivery and is paid for the deliveries made for other members. To reduce the Cooperative's exposure to inflation in rental rates for centrally located urban warehouse space, to better manage the Cooperative's overhead for its spoke-hub distribution network and to provide more permanence for its centrally-located hub, the Cooperative acquired a warehouse building in \_\_\_\_\_ in \_\_\_\_\_ at a cost of approximately \$ \_\_\_\_\_. The building was financed by a mortgage (which has since been paid off), a "building fund" assessment collected from the membership and through the reinvestment of members' patronage dividends that would have otherwise been distributed in cash.

The aforementioned reasons for acquiring the warehouse building are directly related to the purpose for which the Cooperative was formed: to maximize collective distribution efficiencies in Product deliveries of the members through the establishment of a collective and cooperative spoke-hub distribution network.

The Cooperative's primary objective in acquiring the warehouse was to establish a certain level of permanence for the centrally located hub of its broad ranging spoke-hub distribution network. By acquiring ownership of its physical location, the Cooperative has enhanced its permanence, ensuring the preservation of both delivery patterns and marketing trends in connection with the operation of its spoke-hub distribution network.

In addition, the warehouse acquisition was designed to limit the Cooperative's exposure to inflation in the rental cost of centrally located commercial space. By acquiring ownership of the warehouse, the Cooperative effectively limited its members' rather broad exposure to inflation in the cost of maintenance and eliminated its rather broad exposure to inflation in the value of commercial real estate.

The Cooperative's third objective in acquiring the warehouse was to better control its overhead. Ownership of the warehouse enhanced the Cooperative's oversight with respect to its physical facilities beyond that which it previously had as an occupying tenant. It thereby provided the Cooperative with the means to better manage its fixed costs, which primarily related to the economic cost of its warehouse facilities.

The building fund assessment was \$ \_\_\_\_\_ per month from each member from \_\_\_\_\_, through \_\_\_\_\_. Certain subsequently admitted members paid catch-up contributions from \_\_\_\_\_ through \_\_\_\_\_. Total contributions to the building fund were accounted for with respect to each member and refunds were issued to members that resigned from the Cooperative. Any remaining building fund balance has since been distributed in accordance with each member's respective entitlement.

Pursuant to Article Fifth of the Articles of Incorporation, the voting rights of the members are equal and no member has more than one vote. Pursuant to Article Sixth of the Article of Incorporation, the property rights and interests of each member in the association are equal, and are to be determined by the proportion that the patronage of each member shall bear to the total patronage of all the members with the association.

Pursuant to Article Two, paragraph (d) of the Cooperative's Bylaws, if a member desires to withdraw from the Cooperative, the member shall give     days notice in writing to the members, who shall then purchase such member's holdings in if and when such purchase can be made without jeopardizing the solvency of the Cooperative.

The Cooperative has distributed its annual profits to its members as a patronage dividend on the basis of the business each member conducted with the Cooperative during the year. The Cooperative's patronage dividend distribution has consisted of cash and written notices of allocation as defined in section 1388(c) of the Code.

The Cooperative generally distributes     percent of its profit before taxes in the form of an annual patronage dividend currently (by the extended due date of its corporate income tax return), with 20 percent of the patronage dividend paid in cash and the remaining 80 percent allocated to each member in the form of written notices of allocation. The Cooperative accrues a non-current liability on its financial statements for the unpaid balance reflecting such 80 percent. Payments are made against this non-current liability as cash becomes available.

Preceding the acquisition of the building in     , the members of the Cooperative elected to reinvest a substantial portion of the profits to increase funds available for such acquisition. Such reinvested profits were accounted for as patronage dividends that were distributed to the members of the Cooperative through written notices of allocation.

Following the acquisition of the building, significant portions of the then current profits of the Cooperative were utilized to satisfy the Cooperative's obligation with respect to patronage dividends that were reinvested in the Cooperative prior to acquisition of the building. In other words, unpaid prior year patronage dividends were satisfied with funds attributable to subsequent year profits. To avoid taxation at the entity level, the Cooperative issued written notices of allocation to its members based on patronage during the current year. Such accounting enabled the Cooperative to pay prior year patronage dividend repayments out of subsequent year profits without incurring an entity level tax.

As of \_\_\_\_\_, the non-current liability balance for unpaid patronage dividends consisted of approximately \$ \_\_\_\_\_ owed to approximately \_\_\_\_\_ current members and \_\_\_\_\_ former members. Such former members have resigned and have been paid their \$ \_\_\_\_\_ refundable membership fee, but have not been paid in full the balance of their non-current patronage dividends that were distributed to them in the form of written notices of allocation.

As noted above, Article Sixth of the Articles of Incorporation provides that the “property rights and interests of each members in the association shall be equal and shall be determined by the proportion that the patronage of each member shall bear to the total patronage of all the members with the association.” Article Nine of the Cooperative’s Bylaws governs patronage and allocation of net earnings, states that “[t]he cooperative’s net earning shall belong to and be held by the cooperative for its members and shall be distributed to them at the close of each fiscal year on a patronage basis.”

With regard to the disposition of assets for proceeds exceeding \$ \_\_\_\_\_, Article Nine, paragraph (f)(4) of the Bylaws provides:

“Net earnings from the sale of any Major Asset (over \$ \_\_\_\_\_) shall be allocated on a compound patronage basis. The calculation period for determining this allocation shall be the fiscal years (starting with the first full fiscal year after acquisition and continuing until the end of the fiscal year including disposal) during which the asset was in service. ‘Compound patronage’ shall be calculated as the sum of each member’s annual patronage percentage divided by the number of years being considered in the calculation.”

Article Nine, paragraph (d) governs the obligations of members of the Cooperative to contribute to the capital of the Cooperative. It provides:

“Members agree to and shall contribute their respective pro rata shares to the capital of the cooperative. Such contributions shall be paid from net earnings due the members by the cooperative...In addition, such further contributions shall be made as the Directors may specify, except that a member’s obligation to make such further contribution in any fiscal year shall be limited to an amount equal to his share of net earnings for the proceeding fiscal year and shall be proportionate to the contributions required of other members.”

Article Thirteen of the Cooperative’s Bylaws governs the distribution of the assets of the Cooperative upon dissolution. It provides:

“Upon dissolution, after all debts and liabilities of the cooperative shall have been paid, and all capital furnished through patronage shall have been retired without

priority on pro rata basis, the remaining property and assets of the cooperative shall be distributed among the members and former members who have left during the current fiscal year in proportion which the aggregate patronage of each member bears to the total patronage of all such members, unless otherwise provided by law. The calculation period for such asset will be the patronage during the life of that asset.”

Because the Cooperative’s membership has declined in recent years as a result of many market and industry factors, including internet Product deliveries, the Cooperative has sold its warehouse building, receiving proceeds of approximately \$ \_\_\_\_\_ and recognizing a gain of approximately \$ \_\_\_\_\_. The Cooperative intends to distribute the net proceeds (reflecting the recognized gain) to the \_\_\_\_\_ current and former member which patronized the Cooperative during the period in which the Cooperative owned the building on a compound patronage basis (as defined in Article Nine of the Cooperative’s Bylaws). The compound patronage calculation will be finalized after the Cooperative’s financial statements for the fiscal year ending \_\_\_\_\_, have been completed.

As described above, the Board of Directors of the Cooperative has determined to allocate the gain from the sale of the building to among the current and former members that patronized the Cooperative during the period in which the Cooperative owned the building based on their respective compound patronage percentages.

Based on the foregoing the taxpayer request a ruling that:

The Cooperative’s distribution of the gain recognized from the sale of its building to the Cooperative’s current and former members based on compound patronage (their respective average annual patronage percentages), for the period commencing \_\_\_\_\_, and ending \_\_\_\_\_, will be treated as a patronage dividend and will be deductible by the Cooperative for federal income tax purposes.

Section 1388(a)(3) of the Code specifies that a patronage dividend must be “determined by reference to the net earnings of the organization from business done with or for its patrons.” That section further provides that the term “patronage dividend” does not include any amount paid to a patron to the extent that such amount is out earnings other than from business done with or for patrons. Further, it does not include earnings from business done with or for other customers “to whom no amounts are paid, or to whom smaller amounts are paid with respect to substantially identical transactions.”

In Rev. Rul. 69-576, 1969-2 C.B. 166, a nonexempt farmers’ cooperative borrowed money from a bank for cooperatives, itself a cooperative, to finance the

acquisition of agricultural supplies for resale to its members. The bank for cooperatives allocated and paid interest from its net earnings to the nonexempt farmers' cooperative which it in turn allocated to its members.

In determining whether the allocation was from patronage sources the ruling states:

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources. Rev. Rul. 690-576 at 167.

The ruling concluded that in as much as the income received by the nonexempt cooperative from the bank for cooperatives resulted from a transaction that financed the acquisition of agricultural supplies which were sold to its members, thereby directly facilitating the accomplishment of the cooperative's marketing, purchasing, or service activities, the income was patronage sourced.

Section 1.1382-3(c)(2) of the Income Tax Regulations defines "income from sources other than patronage" (nonpatronage income) to mean incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage.

In *St. Louis Bank for Cooperatives v. United States*, 224 Ct. Cl. 289, 624 F.2d 1041 (Cl. Ct. 1980), the Court held that interest on demand deposits in farm credit banks or on loans to brokerage funds received by St. Louis Bank for Cooperatives was patronage sourced income. The Court stated that a particular item of income is patronage sourced when the transactions involved are directly related to the marketing, purchasing, or service activities of the cooperative association. 624 F.2d at 1045.

In *Twin County Grocers, Inc. v. United States*, 2 Cl. Ct. 657 (1983), a nonexempt cooperative was denied deductions for patronage dividends for interest on a certificate of deposit bought from a nonpatron bank because the dividend income was not patronage sourced. The Court held that the relation of income activity to the cooperative's business was too tenuous.

Courts have ruled in several instances that income from corporations organized by cooperatives to conduct activities related to the cooperative business is patronage sourced. In *Farmland Industries v. Commissioner*, 78 T.C.M. 846, 864 (1999), *acq.*, AOD 2001-03 (citing *Cotter & Co. v. United States*, 765 F.2d 1102, 1106 (1985); *Land O'Lakes, Inc. v. United States*, 675 F.2d 988, 993 (8<sup>th</sup> Cir. 1982); *Certified Grocers of Cal., Ltd. v. Commissioner*, 88 T.C. 238, 243 (1987); *Illinois Grain Corp. v. Commissioner*, 87 T.C. 435, 459 (1986)), the taxpayer, a cooperative organized for the purpose of providing petroleum products to its patrons, sought to have the proceeds from the disposition of its stock in three subsidiaries classified as patronage-sourced income. In reaching its decision, the Court stated that its task was to "determine whether each of the gains and losses at issue was realized in a transaction that was directly related to the cooperative enterprise, or in one which generated incidental income that contributed to the overall profitability of the cooperative but did not actually facilitate the accomplishment of the cooperative's marketing, purchasing, or servicing activities on behalf of its patrons." 78 T.C.M. at 870.

In *Land O'Lakes, Inc.*, *supra.*, the Court held that dividends received by the nonexempt cooperative from the St. Paul Bank for Cooperatives was patronage derived and could be allocated to Land O'Lakes patrons as deductible patronage dividends. The court noted that the taxpayer was required to acquire and hold the stock to obtain a loan, the proceeds of which were used to finance cooperative activities on favorable terms finding that the subject transaction was not significantly distinguishable from the transaction in Rev. Rul. 69-576.

Section 1.1382-3(c)(3) provides that, in order that the deduction for amounts with respect to income derived from business done with or for the United States or any of its agencies or from sources other than patronage may be applicable, it is necessary that the amount sought to be deducted be paid on a patronage basis in proportion, insofar as is practicable, to the amount of business done by or for patrons during the period to which such income is attributable. For example, if capital gains are realized from the sale or exchange of capital assets acquired and disposed of during a single taxable year, income realized from such gains must be paid to patrons of such year in proportion to the amount of business done by such patrons during the taxable year. Similarly, if capital gains are realized by the association from the sale or exchange of capital assets held for a period extending into more than one taxable year, income realized from such gains must be paid, insofar as is practicable, to persons who were patrons during the taxable years in which the asset was owned by the association in proportion to the amount of business done by such patrons during such taxable years.

In the instant case, the warehouse building was used exclusively used in the Cooperative's business to facilitate the efficient distribution of the members' Product through the establishment of a spoke-hub distribution network serving the collective



interest of the members and, accordingly, the gain will be “patronage sourced.” Further, Cooperative will distribute the income realized from the sale of the building to persons who were its patrons during the taxable years in which the asset was owned by the Cooperative in proportion to the amount of business done by such patrons during such taxable years.

Accordingly, based solely on the above, we rule that:

The Cooperative’s distribution of the gain recognized from the sale of its building to the Cooperative’s current and former members based on compound patronage (their respective average annual patronage percentages), for the period commencing \_\_\_\_\_, and ending \_\_\_\_\_, will be treated as a patronage dividend and will be deductible by the Cooperative for federal income tax purposes

This ruling is directed only to the taxpayer that requested it. Under section 6110(k)(3) of the Code it may not be used or cited as precedent. In accordance with a power of attorney filed with the request, a copy of the ruling is being sent to your authorized representatives.

Sincerely yours,

*Paul F. Handleman*

Paul F. Handleman  
Chief, Branch 5  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)